By All Accounts — Payable

Whom Do You Pay First When Cash Gets Tight?

By PAUL R. SALVAGE

This region and its business community are facing some frightening times. Energy prices are at record highs, which not only affect what we pay at the pump, but push up prices on most goods, as transportation and other costs increase. Furthermore, consumers are unwilling or unable to spend as they have in the past due to these perceived price increases.

As a result, many businesses are experiencing cash-flow problems that they have not experienced for many years and are struggling with how to keep current. Here is some practical advice on how to maneuver through these challenging times.

When the inevitable cash crunch hits, are you prepared for it, and what will you do?

The first thing that needs to be dealt with in order to prevent a crisis is a complete review of your company's budget to determine any areas where there may be some fat or other reasons to curtail expenses. This is a difficult decision because certain expenses that appear discretionary, such as promotional and advertising costs, may be quite essential to keeping a business going in order to get to a turnaround.

A more difficult decision involves personnel costs. These are usually the highest expenses in a business, exclusive of inventory. Cutting back on personnel sends a message to the community — and, more importantly, to your employees — that things are not going well. This could have a deleterious effect on your organization. Therefore, it is important at some point to communicate, with at least the key employees, as to what the situation is with your business and to elicit their help and support during difficult times.

Once you are satisfied that the budget is in proper form and reasonable, how do you ride out the storm?

In almost every business, a substantial amount of the expenses are compensation-related items such as health care and payroll taxes. Certainly the payroll and related costs must be paid in a timely manner in order to maintain the normal business operation. Taxes, including payroll taxes, sales taxes, and others, are not necessarily due on a weekly basis, and if these payments slip, the usual business operations can appear unaffected for a relatively indefinite period of time. For this reason, there is a great temptation on the part of many business owners to use these funds for temporary working capital.

This is probably one of the worst mistakes you can make. Not only do these overdue taxes result in exorbitant interest charges and penalties, but in the event of a disastrous result, such as liquidation of your business, they do not enjoy a priority over that of secured creditors, and if they remain unpaid, they become the personal obligation of the principals of the business.

In most cases they can never be discharged, even in individual bankruptcies. Therefore, it is not in your best interest to use these funds as working capital. You should assiduously make these payments so they do not come back to bite you. Do not give in to the temptation to delay on these items.

Other substantial costs are likely to be loan payments to secured creditors. Typically, secured creditors are banks, and they are secured by liens on substantially all the assets of your business. In virtually every case, they are also guaranteed by the principals, and it is entirely likely that they will have liens on your other assets that are outside of the company's operations, such as homes and bank accounts. These secured creditors have a priority lien on the assets that secure their loans, and as a result have the right to seize and foreclose upon your assets if defaults occur. Obviously no business can survive without its major assets, so these debts need to be handled with great care if not paid.

Many times, secured loan terms can be re-negotiated and modified by agreements with the secured creditors in advance. Such renegotiated terms can be beneficial to both parties. Hopefully, terms can be arrived at that will allow you to reduce your monthly payments, while at the same time providing the secured party greater confidence that the newly negotiated payments can be made.

These negotiations can also be beneficial to lenders in that they can provide information about your business and its future, as well as instill greater confidence that the reduced payments can not only be met, but will give your business the relief that it needs in order to avoid further defaults.

Any further defaults are likely to lead to perhaps a liquidation, foreclosure on assets at fire-sale prices, and not only the loss of your business but substantial losses to the lender, as a result of a forced liquidation sale remedy. The secured creditors, if given the appropriate information, may be willing to work with you to help you through difficult times in the hopes that your business can prosper. This will potentially increase its recovery either by refinancing with other lenders or by maximizing results by an orderly liquidation if things do not pan out as planned.

This is certainly a much better approach and less stressful for all parties as opposed to allowing these loans to go into delinquency due to non-payment. Most secured creditors are willing to work with their borrowers through troubled times as long as they are fully aware of the circumstances and do not feel that they are being further endangered. Therefore, it is best to talk early and often with these lenders in order to receive their help, support, and patience.

Obviously these discussions should be held only after substantial preparation with your financial advisor and attorney, and all parties should be present at any meetings with lenders.

Potential Short-term Cash Relief

Generally this leaves a third group: unsecured trade creditors. These creditors, some of whom are likely your friends and associates, are really at the bottom of the food chain in the event of a foreclosure or other liquidation. They are usually suppliers of goods or services on open accounts, and their rights are generally subject to the secured creditor's claims and the priority tax and wage claims. They have little or no leverage except to cease to deliver goods and/or take legal action.

This is the group that can most likely be worked with in order to obtain some limited relief. Since these creditors stand to lose the most by both their inability to collect the outstanding debt and the potential loss of what may be a good customer, it is likely that they will agree to a limited moratorium on payments as long as they are not prejudiced any further.

They should insist upon and be offered at least payment for any new goods or services delivered from this time on so that they do not lose any further ground. Most likely, a liquidation by secured creditors will leave them high and dry, so there are real incentives for them to provide some relief as long as they are being fairly treated. Hopefully, a relatively short time period for a moratorium on payments will provide the time to scale down costs, increase sales, and take whatever other steps are necessary in order to bring the cash flow back in line.

The best time to deal with these issues is early, before any crisis appears. In this way, companies are most likely to be able to negotiate terms that are helpful without creating a history of broken promises and a breakdown of relationships. The goal is to ultimately reach a commitment that leads to a turnaround of the business.

It is highly likely that a company that would otherwise be a candidate for a reorganization proceeding such as a Chapter 11 bankruptcy can avoid that if these issues are recognized early. The alternatives, although possible, are costly and stressful.

In summary, it is key to recognize the problem early, create a plausible solution, and discuss it openly with the various creditor groups. This planning will enhance the likely survival and future prosperity of any business that is properly planned and operated.❖

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